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IN THE

Supreme Court of the United States

October Term 1974

No. 73-1374

GARLOCK INC.,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

WINTHROP R. MUNYAN
ROBERT D. WHORISKEY
Attorneys For Petitioner
100 Wall Street
New York, N. Y. 10005

Of Counsel:
LESTER D. BAILEY
ALFRED GROTELL

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Garlock Inc. ("Petitioner") prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered on December 12, 1973.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court are officially reported at 58 T.C. 423. A copy of the opinion is submitted as Appendix A.

The opinion of the Court of Appeals for the Second Circuit, which affirmed the judgment of the Tax Court, is reported at 489 F.2d 197. A copy of the opinion is submitted as Appendix B.

JURISDICTION

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

The judgment of the Court of Appeals was entered on December 12, 1973. This Petition for a Writ of Certiorari was timely filed within 90 days of such date pursuant to 28 U.S.C. § 2101(c).

QUESTIONS PRESENTED

Both the Tax Court and the Court of Appeals for the Second Circuit held that Garlock S.A., a Panamanian corporation ("S.A."), was a "controlled foreign corporation" under subpart F (Section 951 et seq.) of the Internal Revenue Code of 1954, as amended (the "Code"), by disregarding for tax purposes 50% of the total combined voting power of S.A. owned by foreign shareholders during the taxable years involved.[1] As a consequence, Petitioner was held to be subject to income tax on S.A.'s undistributed taxable income. Both decisions were based upon a construction of Section 957(a) of the Internal Revenue Code of 1954, as amended [26 U.S.C. § 957(a)], defining the term "controlled foreign corporation", which Petitioner respectfully submits was erroneous. The questions presented for review are as follows:

1. Did the Second Circuit erroneously determine that Garlock S.A. was a controlled foreign corporation during 1964 and 1965 within the meaning of Section 957(a) of the Code by disregarding voting power of S.A. preferred stock?

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[1] During the taxable years involved, Petitioner owned all of S.A.'s voting *common* stock, which represented 50% of S.A. voting power entitled to vote. Non-resident foreign corporations, each independent of Petitioner, owned all of S.A.'s voting *preferred* stock, which carried the remaining 50% of the voting power of S.A. stock entitled to vote.

2. Are the regulations enacted under Section 957 of the Code, which introduce concepts not contemplated by Congress, an invalid extension of the statute?

3. Does Section 951 of the Code impose a direct tax in violation of Article I, section 2, clause 3 and Article I, section 9, clause 4 of the Constitution of the United States, which is not an income tax within the meaning of the 16th Amendment?

STATUTORY PROVISION INVOLVED

26 U.S.C. § 957(a):

> GENERAL RULE—For purposes of this subpart, the term "controlled foreign corporation" means any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.
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STATEMENT OF THE CASE

A. Preliminary Statement

The case involves deficiencies in Federal income taxes determined against Petitioner in the amounts of $93,335.83 and $27,061.49, for the taxable years ended December 27, 1964 and December 26, 1965, respectively (the "taxable years"). The deficiencies were based on section 951[2] which imputes certain types of income[3] of a controlled foreign

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[2] All statutory references to the "section(s)" relate to the Internal Revenue Code of 1954, as amended, (Title 26 of the U.S. Code), unless otherwise provided.

[3] It is not disputed that all of Petitioner's income during the taxable years was foreign base company sales income, as described in section 954(d), which is imputed under section 951 to certain U.S. shareholders of a "controlled foreign corporation."

corporation to its U.S. shareholders, even though such income was neither realized by, nor distributed to, such U.S. shareholders. Section 951 does not become operative unless the foreign corporation is classified as a controlled foreign corporation (hereinafter "CFC") within the meaning of section 957(a).

One of the principal issues of statutory construction in this case is whether, as the Court below held, Petitioner "owned" more than 50% of the "... total combined voting power of all classes of stock entitled to vote ..." within the meaning of section 957(a) of a Panamanian corporation, Garlock S.A. (hereinafter "S.A."), during the taxable years.

B. The Facts

Petitioner is a corporation organized under the laws of New York in 1905. During the taxable years, Petitioner was engaged in the business of manufacturing and selling industrial components. During the taxable years, Petitioner had only one class of common stock outstanding, which was publicly traded on the New York Stock Exchange.

S.A. is a corporation organized under the laws of the Republic of Panama in 1958. S.A. sold Petitioner's products outside the Western Hemisphere. From the time of its organization through December 27, 1962, S.A. had only one class of voting common stock issued and outstanding, all of which was owned by Petitioner.

During the early 1960's, Petitioner's products were becoming less competitive with similar products manufactured in Europe. Studies were undertaken to consider the acquisition by S.A. of existing manufacturing and marketing facilities in Europe.

During 1961 and 1962, S.A. actively considered acqusitions of specific manufacturing and marketing companies.

It began negotiations in 1961 for the acquisition of a French manufacturing company, Chromex S.A. ("Chromex"). S.A. also opened negotiations for the acquisition of two distributing companies, Allpack, S.A.S., an Italian limited liability partnership ("Allpack") and Lauber & Co., a limited partnership ("Lauber"), as well as Pampus KG ("Pampus"), a West German manufacturing and marketing firm. Chromex, which employed approximately 150 personnel, had substantial losses for the period ended December 31, 1962.

In order to effectuate its acquisition program, S.A. required additional capital. Various means of raising capital for S.A. were considered. At the same time, the Revenue Act of 1962 was before Congress and its passage, in some form or another, appeared reasonably certain. One of the elements of the then pending Revenue Act of 1962 were the provisions of subpart F of the Code, which have given rise to the deficiencies at issue in the instant case. Late in 1962, Petitioner's management decided to recapitalize S.A. with a new class of voting preferred stock to be issued for $100,000. In addition to raising new capital for S.A., Petitioner sought through the proposed recapitalization to avoid prospectively the classification of S.A. as a CFC under the then pending Revenue Act of 1962 by transferring 50% of the voting power of all S.A. stock entitled to vote to foreign shareholders with no affiliations to Petitioner or S.A.

By letter, dated December 4, 1962, from Petitioner's president to Petitioner's board of directors meeting that same day, a proposal was made to recapitalize S.A. The proposal called for the creation of a new issue of $100,000 par value callable preferred stock which would carry voting power equal to that of the S.A. common stock. Petitioner's president proposed that the new issue of S.A. voting pre-

ferred stock be sold to non-U.S. shareholders who would not have any interest in exercising their vote independently of S.A.'s single common shareholder, Petitioner. Petitioner's president also proposed that the S.A. voting preferred stock would be callable at par and would not be transferable without the prior consent of S.A. The letter of Petitioner's president, dated December 4, 1962, to the board reported that two foreign investors had been approached who expressed interest in purchasing a new issue of S.A. voting preferred stock.

Petitioner's president believed that the proceeds from the sale of a new class of S.A. voting preferred stock could be used to help finance the pending purchase and expansion of Chromex by S.A. The recapitalization[4] of S.A., as proposed, was unanimously approved by Petitioner's board of directors "when and as approved by counsel."

Outside counsel subsequently advised Petitioner that CFC status for S.A. could not be avoided under the proposal made by Petitioner's president to the board. In view of this advice and in order to make the preferred stock more attractive to foreign investors, the initial proposal was modified to eliminate any call provision by S.A. with respect to its voting preferred stock, to provide for the transfer of S.A. voting preferred stock and, most importantly, to eliminate any possible agreement with S.A. voting preferred shareholders curtailing their voting power. In addition, the concept of arbitration of shareholder disputes was introduced, since the voting power, being equally divided, could result in deadlocks.

The $100,000 par value voting preferred stock under the revised plan of reorganization carried 8 percent cumulative

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[4] S.A. subsequently used all of its newly subscribed capital from its preferred stock, plus all of its accumulated earnings as of December 31, 1962, to acquire Chromex, Allpack, Lauber and to organize Garlock A.G., a Swiss company, and Garlock, GmbH, a German marketing firm. Negotiations to acquire Pampus were unsuccessful.

dividends to its holders and, as before, also carried 50 percent of S.A.'s voting power. To implement these revisions, the stock was sold subject to a subscription agreement which provided essentially as follows:

1. The voting preferred shares would be transferable with the prior written consent of S.A.'s board of directors, which consent could not be unreasonably withheld;

2. In the event of a dispute among the shareholders of S.A. or if S.A. was unable to act due to a deadlock with respect to any corporate matter relating to the business or affairs of S.A. or to the rights, obligations, or ownership of the preferred stock, any shareholder or S.A. could demand final and binding arbitration of the matter;

3. S.A. would maintain at all times a net current asset or working capital position of at least 200% of the total par value of the preferred stock;

4. After one year from issue, each preferred shareholder would have the right on 120 days' written notice to sell its shares back to S.A. at par; and

5. S.A. would furnish each preferred shareholder with financial statements within 30 days of the end of each calendar quarter.

The new issue of S.A. voting preferred stock was sold for $100,000 through Canadian Camdex Investment, Ltd. (hereafter "Camdex"), a wholly-owned subsidiary of one of the potential foreign investors previously contacted by Petitioner's president. Ninety percent of the S.A. voting preferred stock was sold in early 1963 by Camdex to various independent foreign financial institutions who had no prior relationships either with Petitioner or S.A. Ten percent of the S.A. voting preferred stock was retained

as an investment by Camdex temporarily (*i.e.*, until August 23, 1965, when Camdex sold its interest to a Bahamian bank).

During the taxable years, the board of S.A. consisted of a single class of five directors representing all shareholders. Three directors were affiliated with Petitioner and two were not. All directors served for terms ending with the next annual meeting of shareholders or until their successors were elected. Shareholders' meetings were held annually during the taxable years and the same individuals were re-elected at S.A. shareholder's meetings at which both the S.A. common and preferred stock was represented.

C. Opinions Below

Although no agreements, other than those above-mentioned, were ever entered into which could have restricted the voting power of the S.A. voting preferred shareholders, the Second Circuit held that S.A. was a CFC by disregarding all or part of the voting power of S.A.'s preferred shareholders.

REASONS FOR GRANTING THE WRIT

1. The Second Circuit's Construction of Section 957 has an Important Policy Impact on the Administration of Both the Foreign and Domestic Tax Provisions of the Code.

The Second Circuit's opinion in this case represents the first attempt by an appellate court to construe the provisions of section 957. The ramifications of being classified as a U.S. shareholder of a CFC are ominous, in terms of both the record keeping necessary for computing subpart F income, and the significant tax liability which may result. Section 951 imposes a tax liability upon a U.S. shareholder of a CFC even though no income is actually received. The decision below grants the Commissioner of Internal Rev-

enue vast discretionary powers and imposes an onerous burden of proof on taxpayers, which are not sanctioned by the statute.

In determining that S.A. was a controlled foreign corporation, the Second Circuit held that Regulation 1.957-1(b)(2), requiring that voting power provided by a second class of stock in certain circumstances must be disregarded, "... applies exactly to the case at hand." Appendix B, p. B-7. By holding that the voting power owned by S.A.'s foreign shareholders was "illusory", the Second Circuit implicitly held that "more than 50 percent of the total combined voting power of all classes of stock entitled to vote . . ." of S.A. was "owned" by Petitioner within the meaning of section 957 during the taxable years.

Regulation 1.957-1(b)(2) incorporates three factors in determining whether voting power should be "disregarded", viz. a voting conduct test, an earnings-ratio test and a tax avoidance test. None of these elements are found in the statute. A copy of Regulation 1.957-1(b)(2) is submitted as Appendix C.

The legislative history associated with subpart F of the Code, of which section 957 is a key provision, indicates quite clearly that Congress intended a carefully chosen meaning for section 957. Although the general aim of subpart F was broad, Congress' intent to have section 957, a definitional provision, operate with clarity and precision is apparent. Equally clear from legislative history is the effort by Congress to limit section 957 from the broad application originally proposed by the Treasury Department.

Of the many tests for "control" of a corporation to be found in the Code, Congress in the Revenue Act of 1962 selected a standard based upon ownership of the total combined voting power of stock entitled to vote. The latter test had been in the Code for many years and, as noted subsequently, had been strictly construed by the Courts.

Although the section is clear on its face, the Second Circuit sustained the Government's view that section 957 required judicial interpretation. Its opinion states that:

> "The test in the statute is one of ownership of 'voting power,' a term which, to be sure, is open to at least two different interpretations: appellants would relate it solely to the record ownership of the number of votes attached to all classes of stock entitled to vote; appellee's interpretation is that ownership of voting power is to be determined after full consideration of legal and equitable aspects of ownership." Appendix B, pp. B-7 and B-8.

The Second Circuit adopted the interpretation[5] found in Regulation 1.957-1(b)(2) to be controlling. On this basis, section 957 was transformed from an objective to a subjective test.

The impact of the opinion below on the administration of subpart F of the Code, encompassing the foreign tax area, is vast. Perhaps of equal significance, however, is the potential application of that opinion to many other provisions of the Code unrelated to the foreign tax area.

The statutory phrase "total combined voting power" appears in approximately 55 provisions of the Code. Corporate redemptions, corporate liquidations, collapsible corporations, corporate reorganizations, qualified stock options and corporate surtax exemptions are but a few of the areas affected. Submitted as Appendix D is a list of Code provisions using the term "total combined voting power."

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[5] The quotation above from the Second Circuit opinion indicates that the Court neglected to consider Petitioner's Reply Brief, which reviewed in considerable detail the legal and equitable characteristics of ownership of 50 percent of a corporation's voting power. Thus, while Petitioner contended below that section 957 was clear, and required no further interpretation, Petitioner also argued that a full consideration of the criteria of "voting power" within the context of this case would demonstrate that Petitioner did not own more than 50 percent of S.A.'s total combined voting power during the taxable years.

Interpretations of controlled-definition statutes, using language similar to section 957, have been generally consistent. The cases hold that where a stated percentage of voting power is required by the statute to be owned for purposes of determining control, the statute must be strictly applied. *Bausch & Lomb Optical Co.* v. *Commissioner,* 267 F. 2d 75 (2d Cir. 1959); *Granite Trust Company* v. *United States,* 238 F.2d 670 (1st Cir. 1956); *Commissioner* v. *National Bellas Hess,* 220 F.2d 415 (8th Cir. 1955); *Commissioner* v. *Day & Zimmermann, Inc.,* 151 F.2d 517 (3d Cir. 1945); *Berghash* v. *Commissioner,* 43 T.C. 743 (1965), aff'd 361 F.2d 257 (2d Cir. 1966); *Avco Manufacturing Corp.* v. *Commissioner,* 25 T.C. 975 (1956), rem'd on other grounds but accepted as to this issue, 57-2 U.S.T.C. ¶ 10,021 (2d Cir. 1957).

In contrast to the effective control argument pursued so relentlessly by the Commissioner in the instant case, the Commissioner has taken the position in the past that in applying a statutory control test, defined in terms of ownership of a percentage of voting stock, practical or effective control over a corporation may not be substituted for ownership of voting stock. *See* Revenue Ruling 56-613, 1956-2 C.B. 212, which holds that section 368(c) (containing the phrase "total combined voting power . . .") ". . . specifically defined control in terms of direct ownership of stock and not in terms of practical control."

By implication at least, by reason of the opinion below there is an apparent inconsistency with the First and Third Circuits with respect to the proper interpretation of ownership of "total combined voting power." *See Granite Trust Company* v. *United States, supra,* and *Commissioner* v. *Day & Zimmerman, supra.* Moreover, within the Second Circuit, the interpretation of this term appears to be contradictory, even though the statutes involved do not merit diverse treatment. *Avco Manufacturing Corp.* v. *Commissioner, supra.*

The Second Circuit's decision also would affect the provisions of the Code which do not employ the term "total combined voting power," but require a test of ownership of a percentage in *value* of stock. Contending, as was done in the instant case, that Congressional intent required an expansion of clear statutory language, the Government has attempted to apply section 1239 to situations where the control requirement within the apparent terms of the statute was not met.[6] Both the Fourth and Tenth Circuit Courts of Appeal rejected essentially the argument pursued below by the Government in the instant case and accepted by the Second Circuit. *See, Trotz* v. *Commissioner,* 361 F.2d 927 (10th Cir. 1966); *Mitchell* v. *Commissioner,* 300 F.2d 533 (4th Cir. 1962). *See also,* Revenue Ruling 69-109, 1969-1 C.B. 202.[7]

It is submitted that the foregoing considerations necessitate a review of this case by the Court.

2. The Decision of the Second Circuit is Based on an Erroneous Interpretation of Applicable Decisions of the Supreme Court and is in Many Respects Directly in Conflict with Those Cases.

A. Gregory v. Helvering:

To a significant extent the decision of the Second Circuit is based upon that court's interpretation of *Gregory* v. *Helvering,* 294 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934). This landmark case has come to stand for several principles, *e.g.* whether what was done, apart from the tax

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[6] Section 1239 denies capital gains treatment on sales of certain property between an individual and a controlled corporation. Control under section 1239 is defined in terms of a percentage of the *value* of stock owned by a taxpayer or by certain persons related by blood or marriage to the taxpayer.

[7] *See also, Miller* v. *Commissioner,* 32 TCM 294 (1973); *10-42 Corp.* v. *Commissioner,* 55 TC 593 (1971).

motive, was the thing which the statute intended; whether a business purpose should be required in certain circumstances to satisfy the true meaning of a statute; and whether the substance of a transaction should govern over its form. Petitioner takes no exception to these principles.

Gregory v. *Helvering, supra,* involved an attempt by a taxapayer to obtain favored tax treatment under the corporate reorganization provisions of the tax law by forming a corporation whose only purpose was to qualify the transaction within the literal terms of the statute and which was immediately liquidated after the transaction occurred. The Court recognized the legal right of the taxpayer to decrease its taxes by means which the law permitted but held that ". . . the question for determination is whether what was done, *apart from the tax motive,* was the thing which the statute intended." 293 U.S. at 469. (Emphasis added)[8] It is important to note that in *Gregory* v. *Helvering, supra,* following the corporate reorganization, nothing in substance had been altered between the parties.

Looking to the substance of what was done in the instant case, S.A. transferred all legal and equitable rights to 50 percent of the total combined voting power of all S.A. stock entitled to vote to unrelated foreign financial institutions. No rights to that portion of the voting power were retained by Petitioner. The S.A. voting preferred stock issued to foreign shareholders was "entitled to vote." No devices were utilized by Petitioner to require S.A.'s foreign shareholders to surrender, relinquish or diminish their voting power in S.A. At most, it could be said that petitioner

[8] The Government in effect argued below that the transfer of 50 percent of the total combined voting power of all S.A. stock entitled to vote to foreign shareholders who would not have any interest in acting independently of Petitioner could be disregarded because the statute never intended such a result to occur.

wanted shareholders of S.A. who would be the least likely to prove uncooperative. Nevertheless, no legally recognizable means to control[9] the voting power of S.A.'s foreign shareholders were "owned" (using the statutory terminology) or in any way held by Petitioner during the taxable years, whether or not those foreign shareholders had chosen to oppose Petitioner on any matter.

The Court below allowed the tax avoidance motive of Petitioner to dominate the application of section 957 to the facts of this case. In effect, it distorted *Gregory* v. *Helvering, supra,* by ignoring what was done and looking solely to what was accomplished for tax purposes.

This is inconsistent with the Second Circuit's treatment of *Gregory* v. *Helvering, supra,* in an analogous case. *Kraft Foods Company* v. *Commissioner,* 232 F.2d 118 (2d Cir. 1956). It is respectfully submitted that the Second Circuit's application of *Gregory* v. *Helvering, supra,* in the instant case should be reviewed by this Court.

B. United States v. Byrum:

This Court in *United States* v. *Byrum,* 408 U.S. 125 (1972), recently had the opportunity to examine the distinction between the right to act and the power to accomplish the same result. Although the case arose in a

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[9] Petitioner owned exactly 50% of S.A.'s total combined voting power which, disregarding for the moment the arbitration clause, provided Petitioner with a blocking right on matters requiring a majority vote. Petitioner's blocking rights as a 50% shareholder were far different than the ownership of majority voting power required by the statute, which clearly implies the right to initiate and compel corporate action.

completely different context[10], the *Byrum* opinion appears relevant to the issues presented by the instant case.

In *Byrum* the Court defined the term "right", as used in the tax statute, to require an ascertainable and legally enforceable power. The Court found that the term "right" could not be equated with the ability to accomplish a similar result through the influence over corporate directors by a majority shareholder. The Court further recognized that even the right to elect a majority of directors did not confer the legal right to command the directors with respect to their services on behalf of the corporation. Corporate directors, and even the majority shareholder himself, had a fiduciary duty to promote the interests of the corporation and those duties and responsibilities were enforceable according to legal standards entirely unrelated to the needs or desires of any particular shareholder. 408 U.S. at pp. 137-38.

Thus, this Court held in *Byrum* that the term "right" meant an ascertainable and legally enforceable power. In the instant case, Petitioner argued unsuccessfully below that the term "owned" (with respect to ". . . more than 50 percent of the total combined voting power of all classes of stock entitled to vote" under section 957) meant an ascertainable and legally enforceable right to such voting power. Similarly, Petitioner unsuccessfully argued below that the term "entitled to vote" in section 957 should be defined to include all outstanding stock which bestows upon its owner the ascertainable and legally enforceable right to vote.

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[10] *Byrum* involved the question of whether certain stock should be included for Federal estate tax purposes in the gross estate of a decedent pursuant to section 2036(2). The question was whether the decedent, even though he divested himself of legal title to the stock, retained for his lifetime the "right" to designate the persons who would enjoy the income from the transferred property. Upon transferring the stock in a closely held company to a trust, decedent retained the right to vote the transferred stock, the right to veto the sale of the stock by the trustee and the right to replace the trustee with another corporate trustee.

The court below made no findings that the preferred stock of S.A. was not entitled to vote, that S.A. preferred shareholders were not entitled to exercise this voting power, or that the S.A. voting power associated with the preferred stock was not owned by S.A. preferred stockholders.

This Court stated in *Byrum* that "[t]he 'control' rationale, urged by the Government and adopted by the dissenting opinion, would create a standard—not specified in the statute—so vague and amorphous as to be impossible of ascertainment in many instances." 408 U.S. at p. 137, n.10. The control rationale adopted by the court below and set forth in the regulations under section 957 similarly is lacking any standard and rests solely in the discretion of the Internal Revenue Service or the judicial body hearing the case. To this extent, it is respectfully submitted that a comparison of the *Byrum* decision with the opinion below would also indicate the need for a review of the instant case.

3. The Decision Below Sustains the Imposition of a Direct Tax Not Apportioned as Required by the Constitution, and Imposes a Tax Not Sanctioned by the 16th Amendment to the Constitution.

Petitioner contended below that section 951 imposes a tax without apportionment among the states in proportion to population as required by Article I, section 2, clause 3[11] and Article I, section 9, clause 4[12]. Petitioner also argued below that the 16th Amendment[13] to the Constitution did not permit imposition of a direct tax on income of the type described under section 951.

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[11] ". . . Direct Taxes shall be apportioned among the several states . . . according to their respective Numbers . . . ."

[12] "No Capitation, or other direct, Tax shall be laid, unless in proportion to the Census or Enumeration herein before directed to be taken."

[13] "Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The Second Circuit found Petitioner's constitutional argument to be "frivolous" based upon its prior decision in *Eder* v. *Commissioner,* 138 F.2d 27 (2d Cir. 1943), and noted from the *Eder* opinion Judge Frank's ". . . explicit reference to and paraphrase of *Heiner* v. *Mellon,* 304 U.S. 271, 281 (1938)." Appendix B, p. B-12.

As will be discussed below, *Heiner* v. *Mellon, supra,* was based on a statute which was repealed by Congress because of its apparent conflict with this Court's decision in *Eisner* v. *Macomber,* 252 U.S. 189 (1920).

Eisner v. *Macomber, supra,* determined in substance that income realized by one taxpayer (*e.g.,* S.A.) may not be imputed to another taxpayer (*e.g.,* S.A.'s common shareholder, Petitioner). This Court held in *Eisner* v. *Macomber* (252 U.S. at pp. 213-214) that,

> "We have no doubt of the power or duty of the Court to look through the form of the Corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having an equity or right to a partition of the corporate assets, when they have none; indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat this corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder."

The argument that income may be derived under the 16th Amendment on the theory that undistributed corporate profits represent an accession to wealth (*i.e.*, realized income) to shareholders, also was expressly rejected in *Eisner* v. *Macomber, supra.* This Court held (252 U.S. at p. 207) that "income" did not mean a "gain accruing to capital" or "a growth or increment of value" in the investment,

> ". . . but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed and *coming in*, being '*derived*', that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description.
>
> The same fundamental conception is clearly set forth in the Sixteenth Amendment—'incomes, *from* whatever *source derived*' . . . "

The reliance by the Court below upon its prior decision in *Eder* v. *Commissioner, supra,* it is respectfully submitted, was erroneous. The constitutional issue raised in this case was not discussed by the Second Circuit in *Eder* where, it appears, the taxpayer expressly waived that issue. The Second Circuit held *Eder* to be determinative of the constitutional issue raised by Petitioner below, calling specific attention to *Eder's* reliance upon this Court's decision in *Heiner* v. *Mellon, supra.*

Heiner v. *Mellon, supra,* involved § 220 of the Revenue Act of 1918. That statute in substance provided that if a corporation were formed or availed of for the purpose of avoiding tax by accumulating, instead of distributing, its profits, the corporation would not be subject to tax, but its shareholders would be taxed as if they derived the income

directly from the corporation.[14] The Second Circuit apparently was of the view that the review by this Court in *Mellon* of § 220 of the 1918 Act was sufficient authority to hold section 951 constitutional. What the Second Circuit failed to note was that the statutory provision involved in *Mellon* was repealed in the Revenue Act of 1921 to eliminate the concept of a passthrough for tax purposes of income to stockholders and, instead, to substitute a penalty upon the corporation earning income for its failure to make dividend distributions. The Report of the House Ways and Means Committee explained the amendment:

> "By reason of the recent decision of the Supreme Court in the stock dividend case (Eisner v. Macomber, 252 U.S., 189), considerable doubt exists as to the constitutionality of the existing law. . . ." 67th Cong., 1st Sess., H. Rept. 350, pp. 12-13; *Seidman's Legislative History of Federal Income Tax Laws—1938-1861,* p. 852 (Prentice Hall 1938 ed.)

It is respectfully submitted that the authority relied upon by the court below in this case, based on a statute analogous to section 951 which was revoked by Congress because of the application of *Eisner* v. *Macomber, supra,* contradicts, rather than supports, the result reached.

It has never been disputed that section 951 *et seq.* imposes a direct tax in violation of Article I, section 2, clause 3 and Article I, section 9, clause 4 of the Constitution. Both the Court below and the Government, however, appear to view *Eisner* v. *Macomber, supra,* alternatively, either as distinguishable in law from the situation involved in the instant case, or if not so distinguishable, then no longer of "continuing validity." See Opinion Appendix B, p. B-12, fn. 5.

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[14] This Court did not discuss any constitutional issues in *Mellon,* possibly because § 220 of the Revenue Act of 1918 was repealed by the time that the *Mellon* case was heard by this Court.

Treasury Secretary Dillon's partial reliance upon the Commerce Clause of the Constitution as justification for the Treasury's position on section 951's constitutionality in testimony before Congress may have been indicative of the Treasury Department's basic uncertainty about section 951 under the 16th Amendment to the Constitution. As Petitioner argued below, the attempt to bring section 951 within the purview of Congress' power to regulate commerce is believed to be incorrect under a long line of decided cases. Equally erroneous has been the Government's attempt below to sustain the validity of section 951 under Congress' power to regulate the value of money under Article I, section 8, clause 18 of the Constitution. In any event, the Second Circuit's opinion, overriding the landmark decision in *Eisner* v. *Macomber, supra,* appears worthy of consideration by this Court.

CONCLUSION

For the reasons aforesaid, it is respectfully prayed that a writ of certiorari be granted to review the judgment of the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

WINTHROP R. MUNYAN
ROBERT D. WHORISKEY
Attorneys For Petitioner
100 Wall Street
New York, N. Y. 10005

Of Counsel:
LESTER D. BAILEY
ALFRED GROTELL

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MAR 11 1974

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IN THE

Supreme Court of the United States

October Term 1974

No. 73-1374

GARLOCK INC.,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPENDIX

Of Counsel:
LESTER D. BAILEY
ALFRED GROTELL

WINTHROP R. MUNYAN
ROBERT D. WHORISKEY
Attorneys For Petitioner
100 Wall Street
New York, N. Y. 10005

Appendix A

GARLOCK INC., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

Docket No. 1185-69

Filed June 5, 1972.

Petitioner sought to divest itself of voting control of a "controlled foreign corporation" as defined in sec. 957(a) by causing the corporation to issue so-called voting preferred stock for sale to foreign investors, thereby reducing petitioner's ownership to 50 percent of the combined voting power of all classes of stock. *Held:*

1. In determining whether a foreign corporation is a "controlled foreign corporation" as defined in sec. 957(a), a mechanical determination of voting power through stock ownership is not sufficient.

2. More than a formal transfer or issuance of voting stock without the surrender of substantive control is required in order to avoid being classified as a "controlled foreign corporation" within the meaning of sec. 957(a). Sec. 1.957-1(b)(2), Income Tax Regs.

3. The issuance and sale by a foreign corporation of so-called voting preferred stock having equal voting power with the common stock owned by the petitioner did not effectively transfer 50 percent of the voting power to the preferred shareholders.

4. Taxation to U.S. shareholders of the undistributed income of a "controlled foreign corporation" as defined in sec. 957(a) is not unconstitutional.

Opinion, Dated June 5, 1972

Winthrop R. Munyan and *Robert D. Whoriskey,* for the petitioner.

Agatha L. Vorsanger, for the respondent.

QUEALY, *Judge:*

The respondent determined deficiencies in the Federal income tax of the petitioner as follows:

Year ended	*Deficiency*
Dec. 27, 1964	$93,335.83
Dec. 26, 1965	27,061.49

Concessions having been made, the issues presented for decision are:

(1) Whether Garlock, S.A., a Panamanian corporation, was a controlled foreign corporation within the meaning of section 957(a) of the Internal Revenue Code of 1954,[1] as amended;

(2) Whether section 951 of the Internal Revenue Code of 1954, as amended, is unconstitutional.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Garlock Inc. (hereinafter referred to as the petitioner) is a corporation which was organized under the laws of New York in 1905. At the time of the filing of the petition herein in March 1969 and at all times pertinent hereto, the principal office of the petitioner was in Palmyra, N.Y.

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[1] All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

Opinion, Dated June 5, 1972

During all periods involved herein, the petitioner was on the accrual basis of accounting. Petitioner filed its corporate income tax returns (Forms 1120) for the taxable year ended December 27, 1964, and December 26, 1965, respectively, with the district director of internal revenue at Buffalo, N.Y.

During the years 1964 and 1965, the petitioner was engaged in the business of manufacturing and selling industrial components such as gaskets, packings, and seals. The petitioner had one class of authorized common stock (2,500,000 shares of $1 par value each) of which 900,000 shares were issued and outstanding during 1964 and 1965. As of December 27, 1964, these 900,000 shares were held by 3,179 shareholders; and as of December 26, 1965, they were held by 3,731 shareholders. All such outstanding shares were publicly traded on the New York Stock Exchange beginning on May 25, 1964.

Garlock, S.A., is a corporation which was organized under the General Corporation Law of the Republic of Panama on April 8, 1958. Garlock, S.A., had $50,000 of paid-in capital in 1958. Garlock, S.A., was a marketing operation organized to market in Europe and Asia the products manufactured by the petitioner and its affiliates. During all periods herein, Garlock, S.A. (hereinafter referred to as S.A.), was on the accrual basis of accounting.

From the time of its organization and through December 27, 1962, S.A. had one class of common stock issued and outstanding, each share with a par value of $100. During this period, all such issued and outstanding stock was owned by the petitioner.

Following the organization of S.A. in 1958, Donald J. Camille (hereinafter referred to as Camille) became its president and treasurer. He continued in those offices from

the time of his appointment in 1958 through 1965. Camille was also the export manager of the petitioner during this period.

At a meeting of the board of directors of the petitioner held on December 4, 1962, A. J. McMullen, president of the petitioner, submitted a written report, dated December 4, 1962, which proposed a recapitalization of S.A. This report stated in part that:

> Our subsidiary, Garlock, S.A., incorporated in Panama in 1958, has served as a holding company and as a selling organization for exports outside the Western Hemisphere. As of June 30, 1962, it had accumulated earnings and capital gains of $400,000 which will not be subject to United States income taxes unless and until they are returned to Garlock Inc. as dividends. It has been our intention to use such untaxed earnings and gains to finance the purchase of the French, Swiss and Italian operations now being negotiated.
>
> The Revenue Act of 1962 contains provisions under which earnings after January 1, 1963 would be taxed currently by the United States whether or not repatriated as dividends. Furthermore, some of the earnings of Garlock, S.A.'s own subsidiaries to be acquired—French, Swiss and Italian, will likewise be taxed whether or not paid as dividends. The above tax liability would result from the Revenue Act's definition of a "controlled foreign corporation".
>
> To avoid this tax result it will be necessary to change the capital stock structure and voting rights in such a way that Garlock, S.A. will no longer be a "controlled foreign corporation" as defined in the Revenue Act.

Opinion, Dated June 5, 1972

On the advice of our special tax counsel (Curtis, Mallet-Prevost, Colt & Mosle), we proposed, with Board approval, to pass 50% of the voting rights to foreigners who will not have any interest in exercising their vote independently of our 50%. The following steps are recommended:

1. Garlock, S.A. will reorganize its capital structure so that it will have a common stock investment of $100,000.

2. Garlock, S.A. will create a new issue, of $100,000 Callable Preferred Stock carrying voting power equal to the common stock.

3. Garlock, S.A. will place this stock with foreign investors who understand our motives and are willing to vote their stock with us in return for an ample dividend rate—probably 8%.

4. Garlock Inc. can be protected from loss of actual control by the following provisions in the preferred stock:

   a. Stock callable at any time.

   b. Preferred stock transferrable [sic] only with consent of Garlock, S.A.

All of the above is permissible under Panamanian laws.

We have approached two foreign investors who understand the situation and we believe one or both of them will invest in the new preferred stock when issued. The two investors are:

Willard International Financial Company
Limited
Nassau, Bahamas
Rinderknecht & Co., AG.
Zurich, Switzerland

If the Preferred Stock is so sold, the proceeds will be useful in the purchase and expansion of Chromex, S.A. The dividend cost of 8% compares with 6½% or 7% which Chromex would have to pay on foreign bank loans for the same purpose.

It is recommended that this Board endorse in principle the above plan so that Garlock, S.A. may be authorized in a stockholders' meeting to proceed accordingly.

The proposed plan of recapitalization was discussed and approved by the board of directors at the meeting of December 4, 1962, subject to the approval of the plan by counsel. With respect to such plan, the minutes of that meeting state in relevant part that:

The President submitted a written report dated December 4 proposing a recapitalization of the Company's wholly-owned subsidiary, Garlock, S.A. whereby the common stock would be increased from $50,000 to $100,000 and a new issue of $100,000 of 8% redeemable preferred stock be issued with voting rights equal to the common stock. Further, it was proposed that the preferred stock be placed with selected foreign investors who could be relied upon to vote their stock with the common. Upon motion duly made, seconded and unanimously carried the management was authorized to vote the corporation's stock in Garlock, S.A. to accomplish the above objectives when and as approved by counsel.

At a special stockholders meeting held on December 26, 1962, the directors and stockholders of S.A. voted to amend the certificate of incorporation of S.A. to provide, insofar as relevant to this proceeding, that the authorized capital

of the corporation be divided into two classes of stock consisting of 1,000 shares of preferred stock with a par value of $100 each, and 1,500 shares of common stock with a par value of $100 each. The preferred stock was given equal voting rights with the common, i.e., one vote for each share of stock, but it was provided with a preference to receive a fixed annual cumulative dividend at 8 percent. At the time of dissolution or liquidation, the preferred stock was given a preference to receive an amount not exceeding its par value. Furthermore, stockholders were given the right to vote in person or by proxy. These amendments were permitted by Panamanian law and were made in accordance with the requirements of the law of that country, and they were duly filed in Panama.

At the time of this special meeting of the S.A. stockholders, the officers of the corporation were Camille, president and treasurer; J. E. Brennan, vice president; J. D. Lynn, secretary; and J. R. Alsdorf, assistant secretary. The directors of S.A. at this time were Camille, McMullen, J. B. Sewell, and William Sheffeld. In addition to holding the above offices and directorships in S.A. at the time of the special meeting, Camille was export manager for the petitioner, and J. D. Lynn was assistant secretary and tax officer of the petitioner. J. R. Alsdorf was the petitioner's secretary. McMullen was the president of the petitioner, and J. B. Sewell and William Sheffeld were vice presidents.

At the same special meeting of S.A.'s stockholders on December 26, 1962, S.A.'s articles of incorporation were amended with respect to the term of the board of directors. Prior to December 26, 1962, the articles provided for the election of directors by majority vote of the stockholders for a term of 1 year, to hold office until their respective successors were elected and qualified. At the special meet-

ing of December 26, 1962, S.A.'s articles of incorporation were amended to provide for the election of directors by majority vote of the stockholders for terms of from 1 to 5 years, the exact term to depend upon the vote at the time of the respective election. The provisions concerning the *terms* of directors both before and after the amendment were in accordance with Panamanian law which provides that the directors of a Panamanian corporation shall be chosen in the manner provided for in the articles of incorporation.

The number of directors of S.A. was at all times fixed in the articles of incorporation of S.A. at not more than nine and not less than three. Prior to 1963, the exact number of directors of S.A. was fixed under article 7 of the bylaws of S.A. at four directors. This provision was in accordance with Panamanian law, which permits the number of directors to be fixed by the bylaws of the corporation. At the special meeting of S.A.'s stockholders on December 26, 1962, the following four directors were elected to serve for a term of 5 years or until their successors were elected and qualified: Messrs. J. R. Alsdorf, Camille, A. J. McMullen, and J. B. Sewell.

Willard International Financial Co., Ltd. (hereinafter referred to as Willard), a Bahamian corporation, was a dealer in non-U.S. investments, selling to non-U.S. investors. Charles W. B. Wardell, Jr. (hereinafter referred to as Wardell), was president and a director of Willard during the period of 1962 through 1965. Canadian Camdex Investments, Ltd. (hereinafter referred to as Camdex), a Canadian corporation, was a wholly owned subsidiary of Willard. Wardell was also an officer of this Canadian corporation.

Wardell became familiar with S.A. through Winthrop Munyan (hereinafter referred to as Munyan), a member of

the law firm of Curtis, Mallet-Prevost, Colt & Mosle, who was counsel to Willard and Camdex and special tax counsel to the petitioner. In November 1962, Wardell discussed with Alsdorf, the secretary of the petitioner and the assistant secretary and a director of S.A., the proposed sale of the preferred stock of S.A., and the possible placement of such stock with foreign investors. Wardell also discussed with Munyan and Alsdorf the effects of the Revenue Act of 1962 on the possible placement abroad of the new issue of S.A.'s new preferred stock. He did not, however, discuss the Revenue Act of 1962 with any of the foreign investors who eventually purchased shares of the S.A. voting preferred stock. During the initial discussions in December 1962 concerning the issuance and the placing of the voting preferred stock with various foreign institutional investors, the contemplated issue of voting preferred stock was at all times referred to as debt by both S.A. and Wardell.

John J. Grady was manager of the petitioner's finance division during the second half of 1962 and the vice president of finance for the petitioner in 1964 and 1965. He was involved in the planning and implementation of the stock sale, and he indicated that the preferred stock was issued "to avoid the impact of the Revenue Act of 1962". He also indicated that some other form of paper could have been issued. Camille was also a party to the planning and implementation of the stock sale. He also indicated that the Revenue Act of 1962 was an important element of that decision.

On December 4, 1962, the same day that McMullen submitted the written report concerning the recapitalization of S.A. to the board of directors of the petitioner, Alsdorf wrote to Wardell stating:

> The way now seems to be clear for the sole stockholder of this company to authorize some capital

changes which will make available preferred stock which your company may purchase as we have discussed.

Assuming that the plan works out and the mechanics can be handled, we will take the following steps:

1. Garlock, S.A. will reorganize its capital structure so that it will have common stock outstanding of $100,000 par value. The additional $50,000 of that now outstanding will probably be issued as a 100% stock dividend, capitalizing $50,000 of earned surplus.

2. Garlock, S.A. will amend its charter to create a new issue of $100,000 par callable preferred stock carrying voting power equal to the common stock. Dividend rate will be 8% per annum payable quarterly.

3. Among other provisions which are of less importance to an investor, the preferred stock would have the following features:

a. Callable at any time after _____, at a 3% premium.

b. Preferred stock transferrable [sic] only with written consent of Garlock, S.A.

It is our hope to have the preferred stock available for purchase sometime between January 15 and January 30, 1963. Other details can be checked with you as we make preparations for the issue but I believe the above information will enable you to sound out potential foreign investors. It is our understanding, of course, that you will retain at least 10% of the issue for your own account.

I am writing Win Munyan to have his office begin the legal work and he might to able to supplement the above as to details not covered.

It was a pleasure to make your acquaintance and to be able to work with you in our mutual interest.

On December 6, 1962, Wardell responded to Alsdorf's letter of December 4, 1962, stating in reply that:

This will acknowledge your letter of December 4 advising that Garlock, S.A. has decided to make available preferred shares which our subsidiary company, Canadian Camdex Investments, Ltd., is interested in purchasing.

I see no problem with the conditions and the steps that you describe. I will be in communication with Win Munyan so that we can assist in getting these things done within your time requirements.

I am planning to spend most of the next week in Nassau and will lay the ground work there after another discussion with Win Munyan here so that the transaction can ultimately be consummated in a routine manner.

I also enjoyed our discussion of this business and am grateful for the opportunity of working this out with your company.

As the result of subsequent discussions, the preferred stock eventually issued by S.A. did not include a callability provision or any absolute restrictions on transferability.

On December 27, 1962, Camdex delivered to S.A. a subscription agreement (hereinafter referred to as the subscription agreement) for 1,000 shares of the newly authorized 8-percent cumulative preferred stock of S.A. at a price

of $100 per share or $100,000 in the aggregate. The subscription agreement was accepted by S.A. on December 28, 1962. The December 27, 1962, subscription agreement provided in pertinent part as follows:

> The undersigned subscriber hereby subscribes for 1,000 shares of the 8% cumulative voting preferred stock, par value of U.S. $100 each, of Garlock S.A., a Panama corporation, at par and will pay the full price of $100,000 against delivery of the shares.
>
> The undersigned and Garlock S.A. understand and agree that the subsription to and ownership of the shares of stock by the undersigned subscriber are subject to the following terms and conditions which shall apply so long as the subscriber owns the shares, such terms and conditions to be binding on any successor or assign of the undersigned subscriber:
>
> 1. The shares shall be transferable only with the prior written consent of the Board of Directors of Garlock S.A., which consent will not be unreasonably withheld and any transfer by operation of law, by assignment, or otherwise without such consent will be void and shall convey no right in or ownership of the shares to the transferee.
>
> 2. In the event that on any corporate matter relating to the business or affairs of Garlock S.A. or to the rights, obligations, or ownership of the preferred stock there is a dispute among the shareholders or Garlock S.A. is unable to hold a stockholder meeting or at such a meeting no vote can be effected because of the action or failure thereof of any common or preferred shareholder, any such shareholder or Garlock S.A. may demand arbitration of the matter so unresolved, such arbitration to be

conducted by one arbitrator chosen by the President for the time being of the International Chamber of Commerce and to be held in New York City in accordance with the rules of arbitration and conciliation of the International Chamber of Commerce. Any decision of the arbitrator shall be final and binding on all shareholders and on Garlock S.A.

3. Garlock S.A. shall maintain at all times a net current asset or working capital position of at least 200% of the total par value of the preferred stock from time to time outstanding. In the event such position is not maintained, any preferred shareholder may demand, on 30 days' written notice, that his shares shall be purchased at par and Garlock S.A. or its designees shall purchase such shares.

4. In the event that at any time after one year from issue, any preferred shareholder shall wish to sell his shares, he shall have the right on 120 days' written notice to Garlock S.A. to sell his shares at par to Garlock S.A. and Garlock S.A. or its designee shall purchase such shares at par.

5. Within 30 days of the end of each calendar quarter, Garlock S.A. shall furnish to all preferred shareholders a statement reflecting its position at the end of the preceding calendar quarter.

6. The undersigned is purchasing these shares for investment.

On January 29, 1963, S.A. issued 1,000 shares of its newly authorized 8-percent cumulative voting preferred stock to Camdex pursuant to the subscription agreement. S.A. received $100,000 from Willard for such preferred stock on January 30, 1963. Camdex assigned 350 shares

of its S.A. preferred stock on February 26, 1963, to Nederlandse. On the same day, Camdex assigned 350 shares of its S.A. preferred stock to Bansco and Co., a nominee for Bank of Nova Scotia. On the same day, Camdex assigned 200 more shares of its S.A. preferred stock to American African Finance Corp. (hereinafter referred to as Finance), a corporation organized under the laws of French Somaliland.

As agreed, Camdex retained 100 shares or 10 percent of the preferred stock. On August 23, 1965, Camdex assigned its 100 shares to Butler's Bank Ltd. (hereinafter referred to as Butler's Bank), a Bahamian corporation. On September 2, 1965, a new certificate for the 100 S.A. preferred shares originally assigned by Camdex to Butler's Bank was issued to Beals & Co., the nominee of the First Bank of Boston International, the U.S. correspondent bank of Butler's Bank. The certificate originally issued to Butler's Bank was canceled. No other sales, assignments, or transfers of S.A. preferred stock occurred during the period ending December 31, 1965. Each of the holders of the S.A. preferred stock executed adherences to the subscription agreement.

At the time of the issuance of the preferred stock, the 8-percent dividend rate for that stock exceeded the interest rate prevailing in the foreign market at that time. When the prevailing rate increased, S.A. increased the rate in recognition "that the cost of money, especially our dollars, was increasing very substantially and we felt that we had to be competitive to attract investment funds from those shareholders".

During the course of his activities with respect to the S.A. preferred stock, Wardell never concluded any formal agreement by which the S.A. preferred stock would not be voted independently of the common stock of S.A.

Opinion, Dated June 5, 1972

John Abell (hereinafter referred to as Abell) was the managing director of the International Co. of Wood-Gundy of Canada, investment bankers during late 1962 and early 1963. Abell contacted the Bank of Nova Scotia which eventually purchased 350 shares of S.A. preferred stock on February 26, 1963. He was unaware of any other arrangement, agreement, or understanding, other than the subscription agreement, between S.A. and the preferred stockholders.

On October 1, 1963, the board of directors of S.A. voted to amend article 7 of S.A.'s bylaws to increase the number of directors from four to five. The increase of the number of directors in this manner was in accordance with Panamanian law, which permits directors to amend the bylaws of a Panamanian corporation unless otherwise provided in the articles of incorporation. At this same meeting, the four directors of S.A. resigned in such order and in such manner and elected successors in such order and such manner that at the end of the meeting the following five individuals had been elected as new directors: Camille, Alsdorf, McMullen, Wardell, and Abell. They were elected to serve for a term to end with the next following annual meeting of stockholders of S.A. or until their respective successors were elected and qualified. At the same meeting, the board of directors of S.A. voted to amend the bylaws in order to increase the number of directors of S.A. from four to five directors.

The formal steps in the process by which the five directors of S.A. were elected on October 1, 1963, to serve until the next annual stockholders meeting are described below. Two of the four directors serving at the beginning of the October 1, 1963, meeting, Sewell and Camille, submitted their resignations at the meeting. The resignation of each individual "as a director for a term of five years from 26

December 1962, was received and accepted" by the remaining directors. At the same meeting, the remaining directors (Alsdorf and McMullen) then elected Camille to succeed himself "for a term to end with the next annual meeting or until his successor is elected." Alsdorf then resigned his 5-year term and was elected as a director to succeed himself for a 1-year term in exactly the same manner as Camille. McMullen then resigned his 5-year term and was elected as a director to succeed himself for a 1-year term in exactly the same manner as Camille and Alsdorf. The three directors then in office (McMullen, Alsdorf, and Camille) thereupon voted at the same meeting to amend the bylaws in order to increase the board from four to five members. They then elected two new directors, Wardell and Abell, each "for a term to end with the next annual meeting of stockholders or until his successor is elected." Thus during 1964 and 1965, the directors of S.A. were as follows:

Directors	*Other affiliations*
Donald J. Camille	President of S.A., export manager of petitioner.
James R. Alsdorf	Assistant secretary of S.A., secretary and general counsel for petitioner.
A. J. McMullen	President and a director of petitioner.
Charles W. B. Wardell, Jr.	President, Willard International Financial Co., Ltd.
John N. Abell	President, Wood-Gundy & Co., Inc.

The five directors named above were duly elected in accordance with article 14 of the S.A. articles of incorpora-

tion and article 16 of the S.A. bylaws. The election was also in accordance with Panamanian law, which provided that vacancies occurring on the board of directors of a Panamanian corporation could be filled by the vote of a majority of the directors in office at the time of such election, unless otherwise provided in the articles of incorporation or the bylaws of the corporation.

No meeting of the stockholders of S.A. was held in 1963. At the annual stockholders meeting held on April 1, 1964, the five directors elected at the S.A. directors meeting of October 1, 1963, were duly elected for a succeeding term of 1 year or until their respective successors were elected and qualified. There were reelected for identical terms at the annual stockholders meeting held on April 7, 1965. Thus, during 1964 and 1965, the directors of S.A. were elected to office for a term of 1 year or until their respective successors were elected and qualified.

During 1964 and 1965, S.A. sent advance notice of stockholder meetings to all its stockholders accompanied by proxies to be used by any stockholder who would not or could not attend a meeting. The preferred stockholders executed such proxies which were voted on their behalf at the 1964 and 1965 annual meetings. The proxies so executed appointed McMullen and/or Alsdorf to vote the stock subject to the proxy "on all matters, including the election of directors, which may come before the 1964 [or 1965] annual meeting of the stockholders."

In 1963, 1964, and 1965, S.A.'s net profit was $94,260.61, $173,382.60, and $50,171.20, respectively. During the same years, the holders of the preferred stock received so-called cumulative dividends of $8,000 per year.

Opinion, Dated June 5, 1972

OPINION

Section 951, which was enacted in 1962, provides that a U.S. shareholder of a "controlled foreign corporation" must include in income his (or its) pro rata share of the corporation's subpart F income (defined in section 952) whether or not it has been distributed to the shareholder. The parties have stipulated that all of S.A.'s income was subpart F income, and there is no question that the petitioner is a "United States shareholder" as defined in section 951(b). Consequently, the only issue for decision in this case is whether S.A. was a "controlled foreign corporation" during 1964 and 1965 within the meaning of section 957(a), which provides as follows:

> (a) GENERAL RULE.—For purposes of this subpart, the term "controlled foreign corporation" means any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

At the outset, petitioner argues that section 957(a) "imposes only a mechanical test of voting power through stock ownership," as distinguished from substantive control. In other words, petitioner contends that applying the statute literally it did not own stock having more than 50 percent of the voting power of all of the stock of S.A. Since the remainder of the stock was owned by other than U.S. shareholders, S.A. does not fall within the definition of a controlled foreign corporation.

In this respect, we cannot accept petitioner's argument. The concept that mechanical or formalistic compliance with

the statute is sufficient has long been rejected by the courts. See, e.g., *Pinellas Ice Co.* v. *Commissioner*, 287 U.S. 462 (1933); *LeTulle* v. *Scofield*, 308 U.S. 415 (1940); and *Helvering* v. *Limestone Co.*, 315 U.S. 179 (1942).

The purpose of enacting subpart F is clear. With reference to the "tax haven device," a characterization aptly describing the role of S.A., the President's Recommendations on Tax Revision stated:[2]

> On the other hand, I recommend elimination of the tax haven device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation. There is no valid reason to permit their remaining untaxed regardless of the country in which they are located.

In enacting subpart F, the Congress intended to accomplish the stated objective. In its report accompanying the Revenue Act of 1962, the Ways and Means Committee stated:[3]

> Your committee also has ended tax deferral for American shareholders in certain situations where the multiplicity of foreign tax systems has been taken advantage of by American-controlled businesses to siphon off sales profits from goods manufactured by related parties either in United States or abroad. In such

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[2] H. Doc. No. 140, President's Recommendations on Tax Revision, 87th Cong., 1st Sess. (1961).

[3] H. Rept. No. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 462.

cases the separation of the sales function is designed to avoid either U.S. tax or tax imposed by the foreign country.

The basic purpose of the 50-percent test in section 957(a) was clearly designed and intended to exclude from the definition of a "controlled foreign corporation" only those foreign corporations which were not subject to the dominion and control of U.S. shareholders. To enable or to allow U.S. taxpayers to overcome this basic statutory purpose through the issuance of stock certificates to accommodation buyers, without in substance relinquishing control of the foreign corporation, would frustrate the intent of the Congress.

While we recognize the right of taxpayers to cast their plans in such manner as to minimize their tax liabilities, it is equally axiomatic that such plans must have substance in order to achieve the intended result. The incidence of taxation must depend on the substance of the transaction and not its form. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945); *Higgins* v. *Smith*, 308 U.S. 473 (1940); and *Gregory* v. *Helvering*, 293 U.S. 465 (1935). As stated by the Supreme Court in *Gregory* v. *Helvering, supra* at 469, "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. * * * But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."

The respondent thus properly has ruled that more than a formalistic transfer or issuance of voting stock without the surrender of substantive control is required in order to avoid being classified as a controlled foreign corporation within the meaning of section 957(a). Section 1.957-1(b)(2),

Income Tax Regs., provides in part that "Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained." Section 1.957-1(b)(2) further provides in part that:

> The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957. For example, if there is any agreement, whether express or implied, that any shareholder will not vote his stock or will vote it only in a specified manner, or that shareholders owning stock having not more than 50 percent of the total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal ownership of the voting power will be disregarded in determining which shareholders actually hold such voting power, and this determination will be made on the basis of such agreement. Moreover, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised or, if not exercised, will be disregarded if the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings, if the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and if a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under section 957.

The facts in this case bring it squarely within the regulations.

Prior to December 27, 1962, the petitioner owned 100 percent of the stock of S.A. The petitioner thereupon set about to reduce the voting power of this stock to 50 percent of the total combined voting power.

The plan for the sale of the preferred stock was described in a written report submitted by petitioner's president to its board of directors on December 4, 1962. This plan was "to pass 50% of the voting rights to foreigners" who would "not have any interest in exercising their vote independently" of the petitioner's common stock and "who understand our motives" and are "willing to vote their stock with us [the petitioner] in return for an ample dividend rate—probably 8%." The report stated in essence that the creation of the new class of stock was necessary to avoid the provisions of the Revenue Act of 1962, and it is clear that this factor was the primary motivating factor behind the recapitalization. The report also recommended that the transferability of the new stock be restricted in order to prevent the "loss of actual control" by the petitioner.

On December 26, 1962, S.A.'s charter was amended at a special stockholders meeting to provide for 1,000 shares of preferred stock of $100 par value, having voting rights equal to those of the common stock.

On or about December 27, 1962, 1,000 shares of preferred stock of S.A. were issued to Camdex, a Canadian corporation, for $100,000. Camdex, acting as an underwriter, immediately resold 900 of the 1,000 shares to selected foreign corporations.

The preferred stock was subject to certain terms and conditions set forth in a subscription agreement as follows: (1) The preferred stock could not be transferred without

the consent of S.A., such consent not to be unreasonably withheld; (2) S.A. was required to maintain a net current asset or working capital ratio of at least 200 percent of the total par value of the preferred stock, and if such position was not maintained, any preferred shareholder had the right to demand, on 30 days' notice, that his shares be purchased at par by S.A.; (3) at any time after the end of the first year following the issuance of the stock, any stockholder has the right on 120 days' written notice, to demand that S.A. purchase his shares at par; and (4) if any dispute arose with respect to the affairs of the corporation or the rights, obligations, or ownership of the preferred stock, or if S.A. was unable to hold a meeting because of the action or inaction of any stockholder, any stockholder could demand arbitration, and the decision of the arbitrator was final and binding on all the stockholders.

We thus have a situation where by the simple expedient of issuing a so-called preferred stock for a consideration of $100,000, paying 8 percent per annum, carrying with it ostensible voting rights equal to the common stock, S.A. sought to avoid being classified as a controlled foreign corporation as defined in section 957(a). It is clear that the principal purpose, if not the sole purpose, of the creation and issuance of the preferred stock was to avoid the impact of the controlled foreign corporation provisions of the Revenue Act of 1962. It is also clear that the percentage of voting power attributed the preferred stock was far greater than and substantially disproportionate to its share of the earnings. The preferred stock was entitled to only a very small percentage of the profits, i.e., 8 percent on the investment of $100,000. Finally, there was never any intent that the preferred shareholders would exercise voting rights independently of the common stockholders. On the contrary, as will be pointed out, nothing could be gained thereby.

In our opinion, the preferred stock should be disregarded in determining whether U.S. shareholders owned more than 50 percent of the voting power of S.A. To hold otherwise would require us to disregard completely the respondent's reglations. (Cf. sec. 1.1957-(b)(2), Income Tax Regs.) However, while the responent's regulations provide criteria to determine whether the requisite control is present, our decision need not rest solely on the regulations.

Prior to the issuance of the preferred stock, S.A. admittedly was a "controlled foreign corporation" within the meaning of section 957(a). As sole stockholder, petitioner owned more than 50 per cent of the combined voting power of all classes of stock entitled to vote. The real question is whether the petitioner effectively divested itself of such voting power or, conversely, whether the owners of the preferred stock acquired 50 percent of the voting power. On paper they did. In fact, they did not. After all of the elements of the plan had been implemented, there was in actuality no substantive change in the control of S.A.

On December 4, 1962, McMullen proposed to the petitioner's board of directors the recapitalization of S.A. through the issuance of preferred stock. McMullen proposed, with board approval, "to pass 50% of the voting rights to foreigners who will not have any interest in exercising their vote independently of our 50%" and to have S.A. "place this stock with foreign investors who understand our motives" (to avoid the effect of the Revenue Act of 1962) "and are willing to vote their stock with us in return for an ample dividend rate—probably 80%." The manipulation and selection of the S.A. board of directors which followed negative any intent on the part of the petitioner to relinquish the control represented by the common stock.

Opinion, Dated June 5, 1972

At a special stockholders' meeting held on December 26, 1962, at which the articles of incorporation of S.A. were amended to provide for the creation of the new class of preferred stock, the stockholders (the petitioner) also voted to amend the articles to provide for a term of office for directors of S.A. of 1 to 5 years "depending on the vote at the time of the respective election by the majority vote at annual stockholders' meetings or any such stockholders' meetings called for that purpose." The bylaws of S.A. provided for a board of four directors, and at the December 26, 1962, stockholders' meeting, four officers of the petitioner were elected by the petitioner as the sole stockholder for 5-year terms or "until their successors have been elected and qualify."

At a special meeting of the S.A. board of directors held on October 1, 1963, the board of directors of S.A. amended the bylaws of S.A. to provide for a board of five directors. Two of the four directors (Sewell and Camille) then resigned. The remaining two directors (Alsdorf and McMullen) then elected Camille for a term to end with the next annual meeting or *until his successor was elected.* Alsdorf then resigned and was reelected by Camille and McMullen for the same term. McMullen then resigned and was reelected in the same manner and on the same basis. These three directors, all officers of the petitioner, then voted to amend the bylaws to provide for five directors instead of four. They then elected Wardell and Abell, who were presumably selected to represent the preferred stock, for a term to end with the next annual meeting or until their successors were elected.

Prior to the annual stockholders' meeting held on April 1, 1964, the preferred stockholders executed proxies enabling McMullen and Alsdorf to vote their shares at the

annual meeting. McMullen and Alsdorf elected the same individuals for a term of 1 year or until their successors were elected. This same process was repeated at the annual stockholders' meeting held on April 7, 1965.

The respondent argues that the directors thus elected were by law entitled to serve for the unexpired 5-year term, if not removed by the majority vote of the stockholders. Therefore, respondent concludes petitioner had insured its control during the 5-year term. In support of this argument, respondent contends that the term of office of the directors, having been fixed by the stockholders, could not be reduced or enlarged by the board of directors. We find it unnecessary to resolve that issue. The board of directors was elected to serve until their successors were duly elected. In the event that the stockholders could not agree, the board would remain in office. Barring arbitration, there was no means whereby the preferred shareholders could, if they had wished to do so, challenge that control.

From the standpoint of the holders of the preferred stock, arbitration was not a viable solution to a deadlock. Their interest was limited to the repayment of their investment with accumulated dividends or interest. That much, they could demand at any time.[4] Rather than engage in a costly, if not futile, dispute with respect to control of S.A., the preferred shareholder need only demand repayment.

In our opinion, the actual control of S.A. at all times rested in the petitioner as owner of the common stock. That was the intention, and it was effectively carried out.

Finally, the petitioner argues that the tax imposed by section 951 is in violation of the Constitution of the United

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[4] During the years under consideration, the holders of the preferred stock could demand that S.A. repurchase their stock on 120 days' notice.

States. However, we have held that the petitioner, the sole American stockholder of S.A., did not in substance relinquish control of said corporation. Under these circumstances, section 951 taxes a proportionate share of the income of the corporation to the petitioner. There is no constitutional bar to such a tax. In *Eder* v. *Commissioner*, 138 F. 2d 27 (C.A. 2, 1943), the court upheld the constitutionality of the then applicable provisions concerning foreign personal holding companies, which, under the facts of that case, required the taxpayers to report as income the undistributed net income of their Colombian corporation. This was so even though, under Colombian law, they were unable to receive such income in the United States in excess of $1,000 per month.

Further, case law is replete with decisions holding that income paid to one entity may, under certain circumstances, be taxed as another's income.[5] The courts have also accepted constructive receipt of income as an appropriate basis for taxation in numerous areas of the tax law. See, e.g., *Heiner* v. *Mellon*, 304 U.S. 271 (1938); *Gregory* v. *Helvering*, *supra*.

Consequently, we find that the tax imposed on the petitioner by section 951 is not in violation of the Constitution of the United States.

Reviewed by the Court.

Decision will be entered for the respondent.

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[5] See, e.g., *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282 (1938); *Burnet* v. *Wells*, 289 U.S. 670 (1933). See also *Corliss* v. *Bowers*, 281 U.S. 376, 378 (1930), wherein the Supreme Court stated: "But taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid."

Opinion, Dated June 5, 1972

TANNENWALD, *J.*, concurring: I agree with the result reached by the majority herein solely on the ground that on all the facts, it seems clear to me that there was an agreement (albeit not a formal one) on the part of Camdex either not to vote the preferred shares it retained or to vote such shares in accordance with petitioner's wishes. On this basis (and without regard to whether there was such an agreeement on the part of the other preferred shareholders), petitioner owned "more than 50 percent of the total combined voting power of all classes of stock entitled to vote" within the meaning of sections 957(a) and 958(a). The majority opinion is unclear as to the significance which it attaches to the fact that petitioner's representatives constituted a majority of the board of directors of S.A. during the taxable years involved. In my opinion, that fact represents nothing more than some evidence that there was such an agreement; it does not constitute an independent basis for concluding that the requisite control existed. Given the particular fact situation involved herein and the ultimate conclusion flowing therefrom, it remains for future decisions to determine whether the totality of section 1.957-1(b)(2) of respondent's regulations is a valid implementation of the statutory provisions.

BRENNEN, RAUM, FEATHERSTON, and STERRETT, *JJ.*, agree with this concurring opinion.

Appendix B

United States Court of Appeals

FOR THE SECOND CIRCUIT

No. 60—September Term, 1973.

(Argued October 24, 1973 Decided December 12, 1973.)

Docket No. 72-2108

GARLOCK INC.,

Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

Before:

SMITH, MANSFIELD and OAKES,

Circuit Judges.

Appeal from a decision of the Tax Court upholding a determination by the Commissioner of Internal Revenue of deficiencies in appellant's income tax for fiscal years 1964 and 1965.

Affirmed.

ROBERT D. WHORISKEY, New York, N. Y. (Curtis, Mallet-Prevost, Colt & Mosle and Winthrop R. Munyan; Lester D. Bailey; and Alfred Grotell, New York, N. Y., of counsel), *for Appellant.*

DAVID E. CARMACK, Washington, D. C. (Scott P. Crampton, Assistant Attorney General of

the United States; Meyer Rothwacks; and Elmer J. Kelsey, on the brief), *for Appellee.*

OAKES, *Circuit Judge:*

This is an appeal from a decision of the Tax Court 58 T.C. 423 (1972) determining deficiencies in income tax from the appellant, Garlock Inc. (Garlock), for its fiscal year ending December 27, 1964, in the sum of $93,335.83, and that ending December 26, 1965, in the sum of $27,061.49. These determinations were made on the basis that Garlock, S.A. (S.A.), a Panamanian corporation and originally a wholly owned subsidiary of appellant, was a "controlled foreign corporation" (CFC) within the meaning of § 957 (a) of the Internal Revenue Code of 1954, as amended, and against the claim that § 951 of the Internal Revenue Code of 1954, as amended, is unconstitutional. Section 951, which was enacted in 1962, provides that a United States shareholder of a CFC must include in income its pro rata share of the corporation's "subpart F income," as defined in § 952, whether or not that income has been distributed to the shareholder. All of S.A.'s income was subpart F income, and there is no question that appellant is a "United States shareholder" within § 951(b). Thus the primary question before the court is whether S.A. was a CFC during 1964 and 1965 within § 957(a), which provides in pertinent part as follows:

> The term "controlled foreign corporation" means any foreign corporation of which *more than 50 percent of the total combined voting power* of all classes of stock entitled to vote *is owned* (within the meaning of § 958(a)), or is considered as owned by applying the rules of ownership of § 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

(Emphasis added.) While appellant concedes that it owned 50 per cent of the "total combined voting power" of all classes of stock entitled to vote, it contends that it did not own "more than 50 per cent" thereof so that S.A. was not a CFC. We disagree and affirm the Tax Court.

Appellant in 1964 and 1965, the tax years in question, was a publicly owned and listed manufacturer of industrial components such as gaskets, packings and seals. In 1958 it had organized S.A. with $50,000 in paid-in capital and for the purpose of marketing appellant's products in Europe and Asia. Through December, 1962, S.A. had one class of common stock issued and outstanding, all of which was owned by appellant. On December 4, 1962, however, the president of appellant submitted a written report to his board of directors proposing a recapitalization of appellant's subsidiary, S.A. That report, quoted in full in the Tax Court opinion, urged that, because the Revenue Act of 1962 contains provisions taxing earnings of CFC's after January 1, 1963, whether or not those earnings were repatriated as dividends, "To avoid this tax result it will be necessary to change the capital stock structure and voting rights in such a way that Garlock, S.A., will no longer be a 'controlled foreign corporation' as defined in the Revenue Act."

The report went on to spell out the proposed revision of the S.A. capital structure: Garlock would retain a $100,000 common stock investment (1,000 shares, $100 par) but S.A. would create a new issue of $100,000 callable, cumulative preferred stock (1,000 shares, $100 par), the preferred shares each to be entitled to one vote along with each common share. The report went on to propose that S.A. would "place this stock [the preferred] with foreign investors who understand our motives and are willing to vote their stock with us in return for an ample dividend rate—probably 8 per cent." It pointed out that

Garlock would be "protected from loss of actual control by the following provisions in the preferred stock: a. Stock callable at any time. b. Preferred stock transferrable [sic] only with consent of Garlock, S.A." The report mentioned specifically two foreign investors who had been approached and had said that they "understood the situation," and expressed the belief that one of them would "invest" in the new preferred stock when issued.

The report was approved by Garlock's board of directors at the December, 1962, board meeting and the necessary authority delegated to management; the recapitalization was duly carried out by the directors and shareholders of S.A. under Panamanian law. The same special meeting of S.A. shareholders authorizing the recapitalization and the issuance of voting preference stock also amended the articles of incorporation to provide for the election of directors by a majority vote for terms of from one to five years, the term to depend upon the vote at the time of the respective election, and elected four directors to serve for a term of five years or until their successors were elected and qualified. These four included Garlock's president, vice president, export manager, and assistant secretary.

One of the two specifically mentioned investors in appellant's president's report was Willard International Financial Co., Ltd. (Willard), a Bahamian corporation, which happened to have as counsel the same law firm which was tax counsel to appellant. Willard was the parent corporation of Canadian Camdex Investments, Ltd. (Camdex), a Canadian corporation; Camdex subscribed to the S.A. preferred stock. While the callability provision and absolute restrictions on transferability were not included as terms of the subscription agreement, it was provided that the shares were to be transferable only with the prior written consent of the board of directors of S.A., which consent was not to be "unreasonably withheld." Additional safeguards

to the subscriber included: (1) a provision for arbitration in the event of any dispute between the holders of the preferred and common shares as to any corporate matter relating to the business or affairs of S.A. or the rights, obligations or ownership of the preferred stock; (2) a provision to the effect that at all times S.A. was to retain a net current asset or working capital position of at least 200 per cent of the total par value of the preferred stock, *i.e.*, $200,000, in the absence of which any preferred shareholder could demand a purchase at par by S.A.; and (3) a provision giving each preferred shareholder the right after one year from date of issue, on 120 days' written notice, to sell the preferred stock to S.A. at par.

Camdex subscribed for the full $100,000 of S.A. preferred with money from its parent, Willard, and retained 10 per cent of the 1,000 shares it thus received, selling 350 shares in February of 1963 to Nederlandse Overzee Bank, N.V., 350 shares to a nominee company for the Bank of Nova Scotia, and the remaining 200 shares to American African Finance Corp., a corporation organized under the law of French Somaliland. At the time of the issuance of the preferred stock the 8 percent dividend rate it carried exceeded the interest rate prevailing in the foreign market. On October 1, 1963, the board of directors under Panamanian law duly amended S.A.'s bylaws to increase the number of directors from four to five; three Garlock men were retained, but the president of Willard (who was also an officer of Camdex) was added to the board as was the managing director of a Canadian investment banking concern which was the ultimate purchaser of the 350 shares bought for the Bank of Nova Scotia. No meeting of the shareholders of S.A. was held in 1963, but at an April 1, 1964, shareholders' meeting the five directors elected at the directors' meeting on October 1, 1963, were duly elected for one year or until their successors were elected and

qualified. They were similarly re-elected on April 7, 1965. The above are the essential facts, and while the Tax Court opinion covers them in more detail, they will do for our purposes.

Appellant argues principally that § 957(a) makes the CFC test only the simple mechanical one of ownership of more than 50 per cent of the voting stock, regardless of the ownership of the voting power. That is, appellant would read the words of the statute, "more than 50 per cent of the total combined voting power of all classes of stock entitled to vote," with utmost literality. Appellant argues that the Tax Court majority opinion substituted an "actual control" test for the numerical statutory test and thereby ignored the plain meaning of the statute, erroneously interpreted the legislative intent and erroneously applied the doctrine of substance over form.

But, to go to the heart of the matter, the Tax Court opinion relied squarely on Treas. Reg. § 1.957-1(b)(2). This regulation provides, *inter alia,* that any arrangement to shift formal voting power away from United States shareholders "will not be given effect if in reality voting power is retained." It provides further that "The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957." In the very situation of this case, where another class of stock is outstanding, the regulation states that

> the voting power ostensibly provided such other class of stock . . . will be disregarded [*1*] *if the percentage of voting power . . . is substantially greater than its proportionate share of the corporate earnings,* [*2*] *if the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and*

> [3] *if a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under section 957.*

(Emphasis added.) Here the Tax Court properly found, on the basis of the original "report" to appellant's board of directors, that a principal purpose of the arrangement was to avoid the classification of S.A. as a CFC; appellant cannot and does not argue to the contrary. While it is suggested that the holders of the preferred *could* have exercised voting rights independently, in fact there is no indication that they did so, and indeed at all times a majority of the board of directors consisted of appellant's officers. Finally, the percentage of mathematical voting power of the preferred shareholders (50 per cent) was substantially greater than its proportionate share of the corporate earnings: in 1963, 1964 and 1965 S.A.'s net profit was $94,260.61, $17,382.60 and $50,171.20 respectively, but the preferred shareholders received dividends of only $8,000 per year—in other words, in the year 1965 a maximum of 16 per cent. The regulation, in short, applies exactly to the case at hand. Appellant's argument that the preferred shareholders of S.A. did exercise their voting rights independently, Brief at 44, is not seriously pressed. Rather, the appellant claims that the regulation must be held invalid as an arbitrary and unsanctioned extension of the statute, one contrary to the "legislative intent."

We believe, however, that the regulation, as applied to the facts in this case, is proper and within the direct aim and purpose as well as the plain meaning of the statute. The test in the statute is one of ownership of "voting power," a term which, to be sure, is open to at least two different interpretations: appellant's would relate it solely to the record ownership of the number of votes attached to all classes of stock entitled to vote; appellee's interpreta-

tion is that ownership of voting power is to be determined after full consideration of legal and equitable aspects of ownership. The statute was enacted to help effectuate "elimination of the tax haven device," as set forth in President Kennedy's recommendations on tax revision, *see* H.R. Doc. No. 140, 87th Cong., 1st Sess. 7 (1961). The Ways and Means Committee report on the Revenue Act of 1962 stated that "Your committee has also ended tax deferral for American shareholders in certain situations where the multiplicity of foreign tax systems has been taken advantage of by American-controlled businesses to syphon off sales profits from goods manufactured by related parties either in the United States or abroad." H.R. Rep. No. 1447, 87th Cong., 2d Sess. 58 (1962). *See also* S. Rep. No. 1881, 87th Cong., 2d Sess. 2, 78-80 (1962). In floor debate on the bill Senator Kerr specifically referred to the fact that, if the bill were passed, "It will no longer be possible to flout our tax laws by simply setting up an address company, say in Panama, to sell goods in Europe which did not originate in Panama, which never in fact were in Panama, and which had nothing to do with Panama." 108 Cong. Rec. 17752 (1962). As Secretary of the Treasury Dillon had testified, the Administration's "primary objective in this field . . . [was] to preserve the integrity of the U.S. dollar and to help in the balance of payments. . . ." Hearings Before the House Committee on Ways and Means on the President's 1961 Tax Recommendations, 87th Cong., 1st Sess. 348 (1961). In the light of this legislative history, the appellee's implementation of congressional intent by promulgation of regulations consistent with the statutory design seems to us plainly correct.[1]

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[1] Appellant argues that the Treasury originally proposed either a voting power or a value of stock test but that since Congress used only the former, there was a "conscious decision to limit the definition of a controlled foreign corporation." Appellant's Brief at 21. This does not mean, however, that the voting power test ultimately

Taxpayers generally are fond of quoting Judge Learned Hand's statement that "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *Helvering* v. *Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). It is sometimes forgotten, however, that it was in that very case that Judge Hand's opinion for this court held that a series of transactions which suited the verbal definition of corporate reorganization in the Revenue Act of 1928 nevertheless did not meet the statutory requirements because the transactions lacked a business purpose and the words of the Act made it evident that the aim of Congress was to approve only reorganizations having such a purpose. As Judge Hand said with reference to the tax statute there involved, "the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create." *Id.* at 810-11. So too, here, it does not advance the cause a very great deal to say that the "purpose" of Congress or the "intent" of Congress was violated by the regulations adopted. Certainly as the statute indicates, Congress had generally in mind the elimination of the tax avoidance device known as "tax haven" corporations. The language it used is subject to the interpretation—one given to it by the Treasury—that it is "real" voting power and not the mere mechanical number

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adopted was to be applied strictly mechanically, as appellant would have it. Nor does it follow that, because the statute requires that the requisite percentage of voting power be owned only on any one day in the taxable year, Congress was thereby rejecting effective voting control as the test in a case where that effective voting control was vested in the United States shareholder.

of votes with which Congress was concerned. As Professor Cox reminded us some time ago, "legislative intention" is really simply a metaphor, which "does not state an all-sufficient rule; it enjoins a point of view and sets a goal to which the judge aspires even while he knows it is beyond attainment." Cox, *Judge Learned Hand and the Interpretation of Statutes,* 60 Harv. L. Rev. 370, 372 (1947). It is significant here that the taxpayer sought out parties who understood both its motives and its situation. It is significant also that the terms of the arrangement worked out were such that the preferred shareholders would have no interest in disturbing the taxpayer's continued control. The stock was made attractive by paying a rate in excess of market for the money advanced. The stake of the preferred shareholders was, moreover, quite limited, since the moment the current asset value of S.A., or its working capital, was not maintained at a level of at least 200 per cent of the total par value of the preferred, *i.e.,* $200,000, any preferred shareholder could demand a purchase by S.A. at par; indeed, after one year the preferred shareholders had the right on 120 days' written notice to require S.A. to purchase the preferred at par, that is, to have his original investment returned in full.

While the arbitration provision in respect to unresolved matters we might assume to be proper under Panamanian law—without indicating whether indeed Panamanian law was applicable[2] or, if applicable, that the provision would

[2] The subscription agreement, Exhibit 8, was in the form of a letter from Camdex accepted by S.A. It does not refer to any particular law to govern the interpretation or operation of the agreement. The arbitration paragraph (2) provided, *inter alia,* that there would be one arbitrator, that he would be chosen by the president of the International Chamber of Commerce, and that the arbitration would be held in New York City. Canadian, Bahamian and New York law are all possible alternatives to Panamanian law; there may be others.

be valid[3]—there is no question but that there would be little or no reason ever to resort to such an unrealistic way of running a corporation in light of the working capital and provisions for the repurchase of the preferred stock above recounted. We say "unrealistic" because the picture of corporate sales, management and other decisions in the fast-moving international trade world of the mid-1960's being made through the process of arbitration under the rules of the International Chamber of Commerce is very nearly risible—the product, perhaps, of an imaginative tax lawyer's drafting contemplation, surely not a working solution to real business needs. Without belaboring the point one is tempted to think of the arbitration provisions of the subscription agreement as sugar coating on the taxpayer's Treasury Department pill.

While in a given case the issuance of a different class of stock with equal voting rights might meet the "voting power" requirement in the statute, quite obviously Congress could not generally have conceived all the ramifications of corporate laws around the world which might cleverly be utilized to make a preferred stock which was rather readily redeemable and carried only a very small percentage of the earnings as interest the equivalent in voting power of common stock held by the United States shareholders.

We agree with the appellee that the preferred shareholders' voting power here was "illusory."[4] We agree also

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[3] For example, under New York law, were it held to apply, a corporation's affairs cannot be run under an agreement depriving directors of their power to act for and in the best interests of the corporation. *Ripley* v. *Storer*, 139 N.Y.S.2d 786 (Sup. Ct.), *aff'd*, 286 App. Div. 844, 142 N.Y.S.2d 269 (1955), *modified on other grounds*, 309 N.Y. 506, 132 N.E.2d 87 (1956).

[4] This renders inapplicable such cases as *Granite Trust Co.* v. *United States*, 238 F.2d 670 (1st Cir. 1956), relied upon by appellant,

that the regulation is valid and proper as applied to the facts presented. The argument that § 951, which requires an American shareholder to include in income his pro rata share of a CFC's profits, is unconstitutional we think borders on the frivolous in the light of this court's decision in *Eder* v. *Commissioner*, 138 F.2d 27, 28 (1943). That case held constitutional the foreign personal holding provisions of the income tax laws upon which subpart F was patterned, permitting taxation of United States shareholders on the undistributed net income of Colombian corporations even though Colombian law made the taxpayer unable to receive such income in the United States in excess of $1,000 per month.[5] *See also Alvord* v. *Commissioner*, 205 F.2d 335 (4th Cir. 1953).

Judgment affirmed.

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where the transfer of 20.5 per cent of the stock of a wholly owned subsidiary to a friendly party was held to give the parent less than 80 per cent of "combined voting power" so as to permit it to recognize a loss on liquidation of the subsidiary under § 112(b)(6) of the Int. Rev. Code of 1939. There the voting power transferred was real.

[5] Appellant argues that the "constitutional" issues presented in *Eder* were in fact "apparently" waived in that case and that, therefore, *Eder* does not control our decision here. We disagree with appellant's reading of *Eder*, and note particularly Judge Frank's explicit reference to and paraphrase of *Heiner* v. *Mellon*, 304 U.S. 271, 281 (1938). Whatever may be the continuing validity of the doctrine of *Eisner* v. *Macomber*, 252 U.S. 189 (1920), as applied to the facts in this case it has no validity under *Mellon*. *See also* cases cited 138 F.2d at 29 n.2.

Appendix C

Income Tax Regulations

§ 1.957-1. Definition of controlled foreign corporation.

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(b) *Percentage of total combined voting power owned by United States shareholders*—(1) *Meaning of combined voting power.* In determining for purposes of paragraph (a) of this section whether United States shareholders own the requisite percentage of total combined voting power of all classes of stock entitled to vote, consideration will be given to all the facts and circumstances of each case. In all cases, however, United States shareholders of a foreign corporation will be deemed to own the requisite percentage of total combined voting power with respect to such corporation—

(i) If they have the power to elect, appoint, or replace a majority of that body of persons exercising, with respect to such corporation, the powers ordinarily exercised by the board of directors of a domestic corporation;

(ii) If any person or persons elected or designated by such shareholders have the power, where such shareholders have the power to elect exactly one-half of the members of such governing body of such foreign corporation, either to cast a vote deciding an evenly divided vote of such body or, for the duration of any deadlock which may arise, to exercise the powers ordinarily exercised by such governing body; or

(iii) If the powers which would ordinarily be exercised by the board of directors of a domestic corporation are exercised with respect to such foreign corpora-

tion by a person whom such shareholders have the power to elect, appoint, or replace.

(2) *Shifting of formal voting power.* Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957. For example, if there is any agreement, whether express or implied, that any shareholder will not vote his stock or will vote it only in a specified manner, or that shareholders owning stock having not more than 50 percent of the total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal ownership of the voting power will be disregarded in determining which shareholders actually hold such voting power, and this determination will be made on the basis of such agreement. Moreover, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised or, if not exercised, will be disregarded if the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings, if the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and if a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under section 957.

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Appendix D

The term "total combined voting power" appears in the following provisions of the Internal Revenue Code of 1954, as amended:

1. § 269. Acquisitions made to evade or avoid income tax, Feb. 26, 1964—Enacted. § 269(a). In general.

2. § 279. Interest on indebtedness incurred by corporation to acquire stock or assets of another corporation, Dec. 30, 1969—Enacted. § 279(d). Taxable years to which applicable.

3. § 279. Interest on indebtedness incurred by corporation to acquire stock or assets of another corporation, Dec. 30, 1969—Enacted. § 279(i). Certain obligations issued after October 9, 1969.

4. § 302. Distributions in redemption of stock, Aug. 16, 1954—Enacted. § 302(b). Redemptions treated as exchanges.

5. § 304. Redemption through use of related corporations, Aug. 31, 1964—Enacted. § 304(c). Control.

6. § 332. Complete liquidations of subsidiaries, Aug. 16, 1954—Enacted. § 332(b). Liquidations to which section applies.

7. § 333. Election as to recognition of gain in certain liquidations, Aug. 16, 1954—Enacted. § 333(b). Excluded corporation.

8. § 333. Election as to recognition of gain in certain liquidations, Aug. 16, 1954—Enacted. § 333(c). Qualified electing shareholders.

9. § 334. Basis of property received in liquidations, Aug. 16, 1954 and Nov. 13, 1966—Enacted. § 334(a). General rule, (b) Liquidation of subsidiary, (c) Property received in liquidation under section 333.

10. § 341. Collapsible corporations, Dec. 30, 1969—Enacted. § 341(e). Exceptions to application of section.

11. § 367. Foreign corporations, Jan. 12, 1971—Enacted.

12. § 368. Definitions relating to corporate reorganizations, Aug. 16, 1954—Enacted. § 368(c). Control.

13. § 422. Qualified stock options, Feb. 26, 1964—Enacted. § 422(b). Qualified stock option.

14. § 423. Employee stock purchase plans, Feb. 26, 1964—Enacted. § 423(b). Employee stock purchase plan.

15. § 424. Restricted stock options, Feb. 26, 1964—Enacted. § 424(b). Restricted stock option.

16. § 425. Definitions and special rules, Feb. 26, 1964—Enacted. § 425(e). Parent corporation.

17. § 425. Definitions and special rules, Feb. 26, 1964—Enacted. § 425(f). Subsidiary corporaion.

18. § 503. Requirements for exemption. § 502. Feader organizations, Dec. 30, 1969—Enacted. § 503(b). Prohibited transactions. Special rule.

19. § 503. Requirements of exemption, Dec. 30, 1969—Enacted. § 503(g). Trusts benefiting certain owner-employees.

20. § 815. Distributions to shareholders, Dec. 30, 1969—Enacted. § 815(f). Distribution defined.

21. § 851. Definition of regulated investment company, Aug. 16, 1954—Enacted. § 851(c). Rules applicable to subsection (b) (4).

22. § 856. Definition of real estate investment trust, Aug. 31, 1964—Enacted. § 856(d). Rents from real property defined.

23. § 864. Definitions, Nov. 13, 1966—Enacted. § 864 (c). Effectively connected income, etc.

24. § 902. Credit for corporate stockholder in foreign corporation, Oct. 16, 1962—Enacted. § 902(d). Less developed country corporation defined.

25. § 951. Amounts included in gross income of United States shareholders, Oct. 16, 1962—Enacted. § 951(b). United States shareholder defined.

26. § 954. Foreign base company income, Oct. 16, 1962 —Enacted. § 954(d). Foreign base company sales income.

27. § 955. Withdrawal of previously excluded subpart F income from qualified investment, Oct. 16, 1962—Enacted. § 955(b). Qualified investments in less developed countries.

28. § 955. Withdrawal of previously excluded subpart F income from qualified investment, Oct. 16, 1962—Enacted. § 955(c). Less developed country corporations.

29. § 957. Controlled foreign corporations; United States persons, Oct. 16, 1962—Enacted. § 957(a). General rule.

30. § 957. Controlled foreign corporations; United States persons, Oct. 16, 1962—Enacted. § 957(b). Special rule for insurance.

31. § 958. Rules for determining stock ownership, Aug. 31, 1964—Enacted.

32. § 972. Consolidation of group of export trade corporations, Oct. 16, 1962—Enacted.

33. § 993. Definitions, Dec. 10, 1971—Enacted. § 993(e). Related foreign export corporation.

34. § 1033. Involuntary conversions, Dec. 30, 1969—Enacted. § 1033(a). General rule.

35. § 1083. Definitions, Aug. 16, 1954—Enacted. § 1083 (c). Majority-owned subsidiary company.

36. § 1102. Special rules, May 9, 1956 — Enacted. § 1102(c) Allocation of earnings and profits.

37. § 1246. Gain on foreign investment company stock, Oct. 16, 1962—Enacted. § 1246(b). Definition of foreign investment company.

38. § 1248. Gain from certain sales or exchanges of stock in certain foreign corporations. Oct. 16, 1962—Enacted. § 1248(a). General rule.

39. § 1248. Gain from certain sales or exchanges of stock in certain foreign corporations. Dec. 30, 1969—Enacted. § 1248(c). Determination of earnings and profits.

40. § 1248. Gain from certain sales or exchanges of stock in certain foreign corporations. Nov. 13, 1966—Enacted. § 1248(d). Exclusions from earnings and profits.

41. § 1249. Gain from certain sales or exchanges of patents, etc., to foreign corporations. Oct. 16, 1962—Enacted. § 1249(b). Control.

42. § 1551. Disallowance of surtax exemption and accumulated earnings credit, Feb. 26, 1964—Enacted. § 1551 (b). Control.

43. § 1563. Definitions and special rules, Dec. 30, 1969—Enacted. § 1563(e). Controlled group of corporations.

44. §1563. Definitions and special rules, Dec. 30, 1969—Enacted. §1563(c). Certain stock excluded.

45. § 1563. Definitions and special rules, Feb. 16, 1964—Enacted. §1563(e). Constructive ownership.

46. § 2107. Expatriation to avoid tax, Nov. 13, 1966—Enacted. 2107(b). Gross estate.

47. § 4914. Exclusion for certain acquisitions, Apr. 1, 1971—Enacted. §1914(c). Export credit, etc., transactions.

48. § 4914. Exclusion for certain acquisitions, Nov. 13, 1966, (d) Loans to assure raw materials sources.

49. § 4914. Exclusion for certain acquisitions. Apr. 1, 1971—Enacted. § 4914(g). Sale of liquidation of foreign subsidiary or sale of foreign branch.

50. § 4914. Exclusion for certain acquisitions. Apr. 1, 1971—Enacted. § 4914(k). Acquisitions of stock or debt obligations in connection with nationalization, expropriation, etc.

51. § 4915. Exclusion for direct investments. Sep. 2, 1964—Enacted. § 4915(a). In general.

52. § 4915. Exclusion for direct investments. Sep. 2, 1964—Enacted. § 4915(b). Special rule for government-controlled enterprises.

53. § 4920. Definitions and special rules. Apr. 1, 1971—Enacted. § 4920(d). Qualified lending and financing corporations.

54. § 4946. Definitions and special rules. Dec. 30, 1969—Enacted. § 4946(a). Disqualified person.

55. § 6038. Information with respect to certain foreign corporations. Aug. 31, 1954—Enacted. § 6038(d). Definitions.